

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
DAVLIN PAINT COMPANY. . ) No. **81A-1433**

For Appellant: Larry Mar  
Certified Public Accountant

For Respondent: Paul J. Petrozzi  
Counsel

OPINION,

This appeal is made pursuant to section **25666<sup>1/</sup>** of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Davlin Paint Company against a proposed assessment of additional franchise tax in the amount of \$1,586 for **the income** year 1978.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for-the income year in issue.

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The sole issue in this dispute is whether appellant has shown that respondent's partial disallowance of the claimed addition to, **appellant's reserve** for bad debts amounted to an abuse of discretion\*.

Appellant is a California corporation engaged in the manufacture of paint and allied products. Appellant maintains its books on the accrual accounting system and accounts for bad debts through a reserve for bad debts.

For the income year 1978, appellant made an, addition of \$22,469 to its reserve for bad debts. Respondent disallowed this addition as being excessive and recomputed, the allowable addition and the reserve based upon the six-year moving, average formula approved in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd. on other grounds, 125 F.2d 977 (6th Cir. 1942). The resulting decrease in allowable addition to reserve resulted in the proposed assessment, Appellant protested the proposed assessment and after due consideration, respondent affirmed its action, This timely appeal followed.

In its memorandum accompanying its notice of appeal, appellant conceded that its computation of the bad debt reserve shown on its 1978 return. was incorrect, Appellant states that it does not wish to challenge the application of the Black Motor Co. formula in this instance, only respondent's computation of the addition allowable for the year in question. Respondent rechecked its figures and discovered that it had computed the allowable addition incorrectly, Respondent agrees that appellant's calculation of the allowable reserve is correct, as follows:

1. Amount charged against reserve less recoveries for 1978 and the five prior years - \$107,888.
2. Trade notes and accounts receivable outstanding at end of the year (total of 1978 and five prior years) - \$1,421,874.
3. Write-off percentage - 7.59 percent.
4. Recomputed reserve balance - \$28,396 (trade notes and accounts receivable at December 31, 1978, \$374,130 at 7.59 percent).

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5. Reserve balance at December 31, 1978, tax basis - \$34,165.
6. Reduction to bad debt expense, - \$5,769.
7. Amount of tax due - \$520.

The revised computation is based on the Black Motor Co. formula which uses historical information to determine the adequacy of the allowance for bad debts. The Black Motor Co. formula is an arithmetical computation which assumes that current bad debts will be equal to the average bad debts of prior years. The formula does not take into account increased risks in collection of accounts receivable as business expands.

The use of the Black Motor Co. formula has frequently been upheld by the courts and this board. Section 24348 grants respondent express discretion with regard to the allowance of reasonable additions to a reserve for bad debts. For this reason, a taxpayer must not only demonstrate that additions to the reserve were reasonable, but also must establish that respondent's action in disallowing those additions was arbitrary and amounted to an abuse of discretion. (See Appeal of H-B Investments, Inc., Cal. St. Bd. of Equal., June 29, 1982.) Appellant has established, and respondent agrees, that the recomputed amount added to its reserve is reasonable.

**For** the reasons stated above, we sustain respondent's action as modified in accordance with respondent's concession.

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O R D E R

Pursuant to the views **expressed** in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Davlin Paint Company against a proposed assessment of additional franchise tax in the amount of **\$1,586** for the income year 1978, be and the same is hereby modified in accordance with respondent's **concession**. In all other respects, respondent's action is sustained.

**Done at Sacramento**, California, this 30th day of July, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

<u>Ernest J. Dronenburg, Jr.,</u>	Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Richard Nevins</u>	, Member
<u>Walter Harvey*</u>	, Member

\*For Kenneth Cory, per Government Code section 7.9